COMMONWEALTH OF MASSACHUSETTS
BEFORE THE
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Investigation by the Department of Telecommunications and Energy on its own Motion into the Provision of Default Service	)	D.T.E. 02-40

SUPPLEMENTAL COMMENTS OF ISO NEW ENGLAND INC.

I. Executive Summary

ISO New England Inc. (the "ISO") hereby respectfully submits these Supplemental Comments in the Massachusetts Department of Telecommunications and Energy ("Department") Docket No. 02-40, "Order Opening Investigation Into the Provision of Default Service."

On August 9, 2002, the ISO timely filed initial Comments that describe the interrelationship of the wholesale electric market and the retail electric market. A main point in the ISO's initial Comments is that retail customers or suppliers must see the true costs of their energy consumption so that price signals will have their intended effect of market efficiency. For example, retail customers or suppliers seeing high energy prices should be incented to reduce their demand, which in turn will help to reduce wholesale energy prices. In related fashion, the ISO described the transition to Standard Market Design, which will introduce locational marginal pricing ("LMP"). The ISO's initial Comments support the recognition in the Default Service Price of LMP, as well as other costs, such as the costs of serving and acquiring load. Those Comments explain how such price signals can help foster demand response. Similarly, those Comments endorse

a default service structure where competitive suppliers have incentive to help customers with implementing or increasing demand response. In that context the ISO also notes that distributed generation is an important resource option in a restructured electric industry. Therefore, the ISO encourages any changes in Default Service structure be coordinated with policy made as a result of the Department's investigation into Distributed Generation (D.T.E. 02-38).

Of course, for a market to work efficiently, the prices of different choices of electric service must reflect all the costs of providing that service. The ISO does not, however, mean to suggest that an arbitrary retail "adder" ought to be included in the price solely for the purpose of fostering the retail market. A vibrant retail market will be, however, the best support for a strong and efficient wholesale market. As a result, retail pricing should be free of subsidies and should reflect all costs of providing the relevant service.

These Supplemental Comments expand on the points made in initial Comments, in the context of various proposals that other parties have offered in their initial Comments. At the same time, these comments also address certain proposals made by other parties in their initial Comments.

In sum, and as described in greater detail below, the ISO urges the Department to revise the rules governing default service as follows:

?? Ensure that accurate price signals are provided to electric customers. Specifically, the default service price should include various costs that are incurred by competitive service providers in acquiring and serving the load, as the market alternative to Default Service. Such costs include administrative costs, bad debt costs and costs incurred to address load variability, where applicable. A default service price that is too low will stifle the demand for alternative competitive supply and hinder the development of a competitive market.

?? Ensure that the transition to Standard Market Design is recognized by reflecting LMP-related wholesale price differences in the default service pricing to help encourage the incentives for demand response. Demand response actions will more likely take place where LMP prices are seen in the retail market. These actions will also have positive impacts in the wholesale and retail electric markets by resulting in more efficient use of resources and reinforcing reliable electricity service.

?? Structure the provision of Default service so that suppliers can benefit from demand response (customer load reduction) that they help initiate. Thus, instead of suppliers supplying only to an undifferentiated portion of a distribution company's load, such suppliers should specifically provide service to identifiable customers, or should in some other manner, be given full credit for load reductions that they initiate.

Conduct Default service procurement so that service periods are of sufficient length to promote demand response investment by retail suppliers.

II. Reliable and Efficient Markets Require That Prices Accurately Reflect All Costs of Providing Service.

A. General Principles

The Department has correctly recognized that the issue of what costs ought to be included in the default service price is an important one. *See* DTE 02-40, "Order Opening Investigation Into the Provision of Default Service," pp. 5-6. Under the current framework, as described by several commenters, end use customers will have the choice of a competitive supply and default service. Under the existing set of rules, in 2005, these will be the only two choices for customers. ISO strongly urges that the Department seek to establish or modify rules so that there is a proper framework for the development of efficient retail markets, including reflection in Default Service pricing all the costs of providing that service.

B. Locational Marginal Pricing Should be Reflected in Default Service Rates.

As discussed above, LMP will be reflected in wholesale prices upon implementation of Standard Market Design, and consequently it should also be reflected in retail prices -- specifically in the price for Default Service. Again, there is wide support in the Initial Comments for that concept. That approach is needed to avoid improper price signals that will distort customer choices and to improve reliability further by identifying those areas that are, for example, capacity deficient. Specifically, if a customer in an area with higher congestion costs faces a choice between a default service – the price of which does not include LMP – and a competitive service that does include LMP, the economic choice *for that customer* is Default Service. Failure to include such costs in default service pricing, however, would hinder the efficient development of *the retail market* and will suppress demand response activities.

Notably, to the extent the Initial Comments filed by other commenters address the issue of LMP, there is significant support for recognition of LMP in the price of Default Service. *See e.g., Western Massachusetts Industrial Customers Group Comments, p. 4; Competitive Retail Suppliers Comments, fn. 2; Bay State Consultants (for various municipal aggregation efforts) Comments, pp. 2-3; Massachusetts Electric Company Comments, pp. 34-35 (at least as to Commercial & Industrial Customers).* Also, the Massachusetts Division of Energy Resources ("DOER") agrees with the concept that the energy portion of Default Service bills should reflect a flow through of differences in wholesale power supply costs due to LMP. DOER correctly observes that such costs are properly considered to be related to the provision of generation services and should be so reflected. It is important, however, that costs due to LMP not be averaged across zones

of congestion and not be subject to variable pricing options based on the type of customer. Permitting end users or their suppliers to see accurately the costs of electricity service will result in a more robust market and will create more fertile ground for demand response.

For example, while large commercial and industrial customers may have larger energy bills and may have equipment that would allow more responsive behavior to energy price signals, this is not to say that retail suppliers serving smaller users would not undertake measures (*e.g.*, aggregating smaller end users) to respond to accurate energy price signals. *See also, e.g., Comments of Bay State Consultants*, pp. 2-3. Moreover, smaller users themselves (*e.g.*, residential users) may undertake new behavior to respond to accurate pricing of electricity (*e.g.*, through energy conservation on peak days or timing certain major electric consuming activities). And even if certain entities do not have "state-of-the-art" technologies for responding to price signals, other technologies or methodologies to respond to such price signals may result from introduction of LMP. Moreover, end users may become more responsive to existing mechanisms that exist that seek to result in demand responsive behavior. These include, for example, encouragement to shift consumption, especially during peak periods, through the news media and public outreach by the ISO and distribution companies. With continuing education and the customers' ultimate realization that they can save a few dollars simply by altering their routine, there could be a material benefit of shifted consumption by many small customers. It may be largely a voluntary effort, but it should be deemed an effort worth promoting – just like town water bans that do receive significant participatory support.

Passing through locational marginal prices at the retail level should result in more optimal market behavior. Designing a retail market in which end users will see accurate price signals – particularly in those congested areas – will incent those entities providing supply at the retail to undertake measures to reduce risk associated with congestion costs – particularly demand side management and distributed generation. Both of these measures result in socially desirable ends – efficient energy consumption and a more reliable power grid.

This is also true for those distribution companies whose service areas cross congestion-pricing zones. To the extent administratively feasible, these companies should also be encouraged to pass through locational marginal prices to end users. In this regard, it is critical that wholesale suppliers are able to collect congestion costs so that they experience the proper incentives to address the issue. As noted above, if wholesale suppliers bear a cost that they are unable to recover, that will reduce or deter their participation in a given market. To the extent that participation by wholesale suppliers does decrease, the wholesale market will necessarily decrease in terms of its vibrancy and efficiency -- clearly an effect that ISO wishes to avoid.

Finally, the issue of coordination of Default Service procurement with implementation of LMP is important to the issues just discussed and is addressed in Section III.

C. Administrative Costs, Uncollectible Costs and Other Retail Costs

To achieve the goal of market efficiency, it is necessary that default service include all the costs of providing that service. *See, Attorney General Comments, p. 6; competitive Retail Suppliers Comments, p. 6; Fitchburg Gas & Electric Comments, p. 2;*

PG&E National Energy Group ("PG&E") Comments, p. 4; Western Massachusetts Electric Co. Comments, p. 2; Nstar Electric Comments, p. 9; DOER Comments, p. 26. That principle applies whether distribution companies continue to provide such service or whether other suppliers begin to provide default service directly, as has been suggested by some commenters. As one commenter aptly described the current status, customers now receive Default Service (a retail product) at a wholesale price. *See Western Electric Massachusetts Electric Co. Comments, p. 1.* Unless such costs are included in the price, default service will always be the economic choice relative to a competitive supply because there are several costs that a competitive supplier cannot avoid in providing retail service. That competitive supplier must either attempt to collect such costs from its customers, which has the unfortunate result of causing competitive service to be higher priced than default service, or it must absorb such costs, which leads to losing money and ultimately abandoning the market. Thus, it is necessary that such costs be included in the default service price. At the least, such costs should include administrative costs, the costs associated with load uncertainty and, depending who bears the risk of collections, the cost of uncollectible accounts. To the extent that suppliers of generation service directly supply default service, they will incur those same costs and ought to be able recover such costs.

III. The Current Structure for Default Service Procurement Can Be Improved.

A. Length of Procurement Periods and Related Pricing

The current policy relative to Default Service procurement is set forth in D.T.E. 99-60-B. In that proceeding, the Department stated that a minimum procurement period is necessary to be able to satisfy the mandate of the Restructuring Act to provide a six-

month fixed price option. The Department also stated that a procurement period longer than one year would progressively lead to greater deviation between monthly bid prices submitted by potential default service providers and the actual monthly price. Therefore, it required procurement periods of between six months and one year. Customers were then allowed to take a fixed price option or a monthly variable price option.

The variable price option allows for a Default Service price to be reasonably conforming to market pricing. At the same time, it is important that the procurement period be sufficiently lengthy so that default service providers have an incentive to invest in demand response mechanisms. Implementing these polices will balance the objectives of wholesale price flow through and creating sufficient stability in the retail market to encourage demand response. Monthly adjustments of price will yield improved price signals and a longer service period will incent appropriate investments by retail suppliers.

B. Procurement Periods Should be Coordinated with Initiation of LMP in March 2003.

At this time, it is expected that LMP will begin in March 2003. With the implementation of LMP there will be changes in some wholesale charges to reflect congestion costs. That change in costs should be a flow through of such costs to retail customers or suppliers, so that the price they experience is not automatically different from the actual wholesale price. The ISO urges the Department to require that Default Service prices reflect LMP costs, at the earliest time practicable, whatever procurement mechanism the Department ultimately supports. The ISO does note that if a staggered system for Default Service procurement is implemented, then each contract under the staggered system (*i.e.*, including transition procurements) should reflect LMP costs as well. To the extent that staggered procurement of Default Service supply is not

implemented in 2003, then, and as noted above, default service prices should be coordinated with the implementation of LMP, to ensure immediate reflection of LMP and to ensure default service pricing mechanisms are not inconsistent with the wholesale market.

IV. Default Suppliers Should Be Identified with Specific Customers.

Several commenters have proposed that Default Service be provided by suppliers other than the distribution companies directly.[1] The ISO believes (with appropriate consumer safeguards that have been discussed in some of the initial Comments) that such direct service will help ease the transition to a more fully competitive market. Further, when suppliers of default service are responsible for actual customers and their load, as opposed to a portion of a distribution company's load where there is no contact with customers or identification of supplier, such suppliers will have the financial/economic incentive to encourage retail customer or supplier load response and other actions that may lead to a reduction in the cost of providing Default Service to a particular group of customers. Such an additional incentive to the development of further load response is very positive from the perspective of the ISO. In contrast, under the current system, the suppliers have their incentive significantly watered down if they serve only a portion of the Default Service load in a given territory -- they will only get a proportional share of that cost savings. Where Default Service suppliers are not directly responsible for, nor directly benefit from, service to specific retail customers, incentives to encourage load response activities are reduced or eliminated. Modifications to the current system that

[1] The ISO notes the concepts of balloting by customers for bidding suppliers (PG&E Comments, pp. 8-9), assignment to bidding suppliers (Duke Energy Trading Comments, pp.2-3; TXU Retail Comments, p. 35; MECO Comments, pp. 13-14) and less complete forms of assignment. DOER Comments, pp. 36-37. Generally, the ISO would support a process that allows customers choice and a rational bidding process.

provide only *some* heightened visibility between Default Service suppliers and customers, as suggested by MECO or DOER, would still result in reduced incentives to engage in load response activities.

CONCLUSION

The ISO commends the Department for addressing these issues and seeking input on these issues. The ISO hopes its comments prove useful to the Department.

Respectfully submitted,

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